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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET In a manner which can only be described as "monumentally persistent", the Industrial Average has continued to push into new all-time high territory. Against this, the action of the market as a whole has been atrocious. As gauged by the advance-decline ratio (see chart #2), the trend of the majority of stocks on the N. Y. S. E. has been bearish since May 31, 1963. Moreover, since late August the Rail and Utility Averages have also been in a declining (diverging) trend.

Breaking down the action even further, it is worth noting that within the Industrial Average itself, two stocks (Chrysler and General Motors) have accounted for well over 50% of the rise since May, 1963.

On September 3, 1963, the senior Average rose above its 1961 (734. 91) all-time high. Since that time, more than 200 million shares have been traded, and daily volume has averaged considerably better than 5 million shares. Yet the percentage of increase in the Industrial Average (in the face of this huge volume) has been unimpressive. Even more ominous, as of October 21 (statistics by my friend Joe Granville) 581 common stocks or almost half of the issues on the "Board" were within 1 to 3 points of their 1963 lows. If divergent trends are the order of the day, we have them to spare.

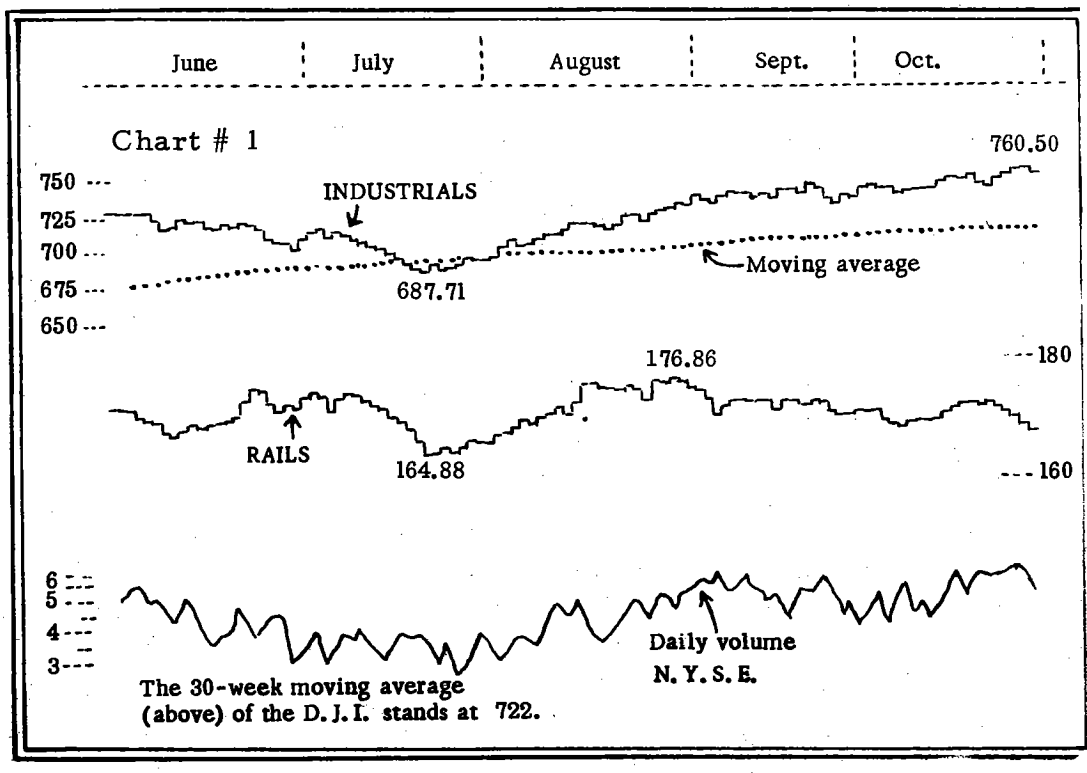
Of further interest: margin requirements are now 50%, and this is equal to the lowest margin requirement since 1945. The last time margins were at 50% was in 1958, at which time total margin loans outstanding amounted to $4. 4 billion. Today margins are back at 50%, but margin loans have increased to $5. 3 billion. The situation, from the standpoint of stock market credit, is highly speculative (see later section on margins).

From the standpoint of fundamental values, the market is also in a highly speculative position. All three Averages are (1) at or near historical highs, and (2) at or near historical peaks in price-earnings multiples. Average dividend yields in the three Averages amount to 3. 1% (Industrials), 4. 1% (Rails), and 3. 3% (Utilities) -- as against 4. 6% on the D-J 40 Bond Average.

I would now be "absolutely certain" that the market was on the edge of a wide-open break -- except that I remember the year 1959. That year (see Letter 234) proved that divergent trends can continue longer than seems logically possible. When will the current divergent action bring trouble? I do not know, but for sheer "cliff-hanging" thrills, this market must be seen to be believed.

A COMMENT: Because the A-D ratio has recently embarked on one of its rare divergent courses (declining while Industrials advance), a number of analysts are claiming that "too much importance is being placed on this indicator." A few investment services have even brought forth the thesis of "analytic fashions", and they have commented upon the popularity of the Confidence Index in 1959-60, the odd-lots in 1961-62 and "now the A-D ratio."

In my opinion, such comparisons are ill-founded. The A-D ratio is not an indicator in the sense that the odd-lot ratio or the short interest ratio or the Confidence Index are "indicators". The concept of the A-D ratio is absolutely fundamental, being based on all price changes on the



N.Y.S.E. I cannot stress too strongly that the A-D ratio provides a daily factual statement about the entire market -- in the same manner that the closing prices of the Averages provide factual statements about fifty representive issues. The Averages tell us how much the thirty industrial and twenty rail stocks are selling for; the A-D ratio tells us whether the majority of issues have been rising or declining. To place the A-D ratio in a "gimmick indicator" catagory is to portray a basic ignorance of the meaning of this study.

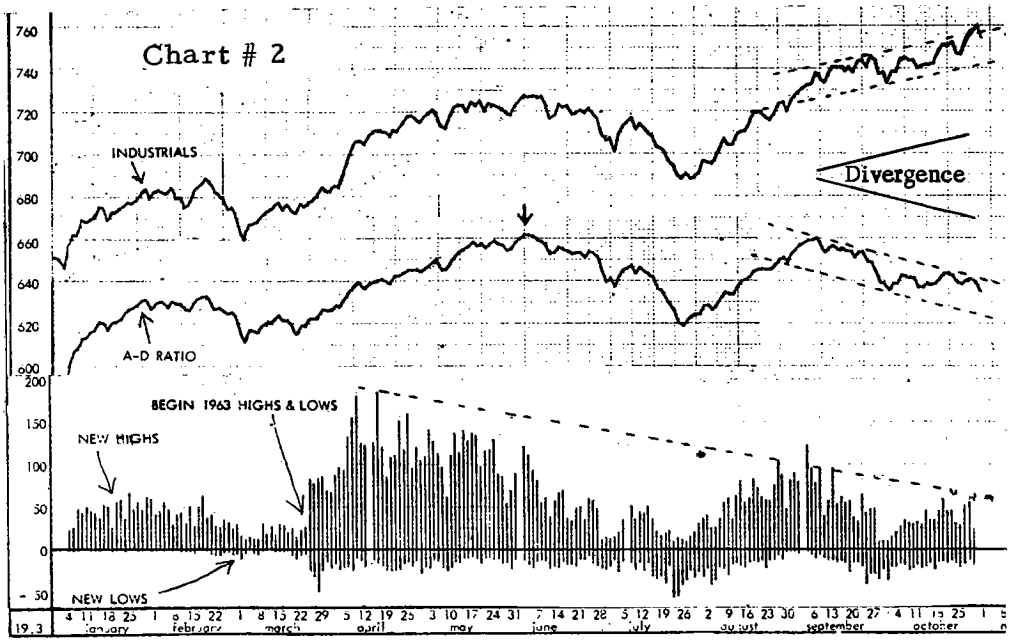
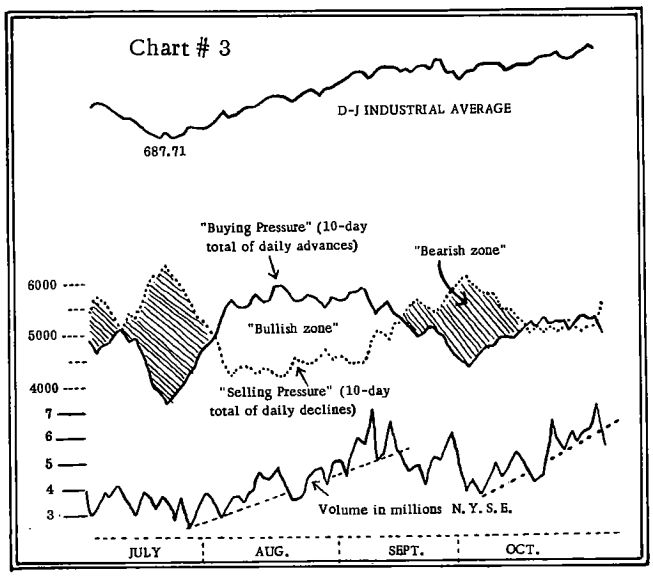
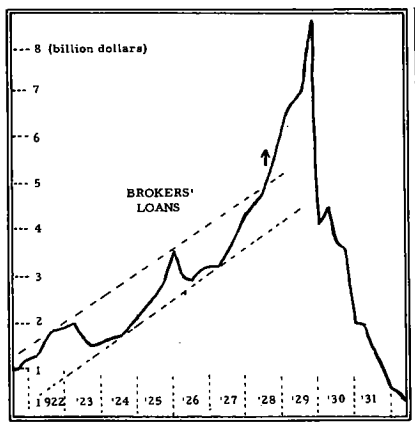


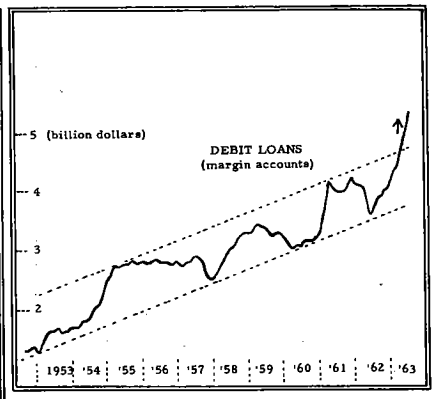
CHART #2 Is practically self-explanatory. It is a technical picture of "more of the same", with Industrials continuing along their upward path while the A-D ratio continues down. At the bottom of the chart we see the daily new highs and lows, and here too the picture is negative. The high-low study is actually a confirmatory one, since it is obvious that if the majority of issues are moving in a downward trend, fewer and fewer daily new highs will appear in the daily statistics.



BUYING AND SELLING PRESSURE On October 11 (see Chart #3) Buying pressure rose slightly above Selling. Since then the two lines have crossed and criss-crossed with neither able to move very far from equilibrium. During this period, daily volume boomed to the highest levels of the year. The fact that the two lines were practically touching while daily volume moved into the 5-7 million share class suggests "churning" and distribution. In order to be bullish, the great volume of the past few weeks should have succeeded in moving the Buying line well above Selling. Note that this is exactly what occurred during August, at which time volume was also expanding sharply.

EXTRA MARGIN (I am indebted to Dr. Sloan Wilson of Kansas City for keeping me constantly abreast of the debit-credit studies). Some months ago I issued a special report concerning "sky-rocketing" margin accounts and the possibility of a final speculative market "blow-off". The situation in the margin sector of the market has now become so similar to the situation of a generation ago that I believe comparisons are in order.





The speculator's "tool" is his margin account. His willingness to use the leverage of margin makes the speculator a powerful force in the market, particularly at critical turns. Since the speculator tends to "get with" the trend very quickly, he may be considered the direct opposite of the odd-lotter. The latter usually "fights" the trend through the early and middle stages of a move, but (ironically) the odd-lotter usually shifts his position in harmony with the market trend at about the time the trend is changing.

A study of history shows that debit balances (or speculators' margin accounts) tend to rise throughout the greater part of an important bull movement. Furthermore, debit balances usually "top out" simultaneously with the Industrial Average, and the two will then decline together.

Once a bull market has terminated and a new bear market has started, the debit balances embark on a major downtrend. Bear markets generally do not end until the speculator is thoroughly beaten -- or until his margin account is down to or below the levels which prevailed when the preceding bull market began.

The accompanying chart traces the rise of brokers' loans through the 1921-29 bull market, and it also traces the subsequent collapse of the margin position during the 1929-32 bear market. Note that towards late 1929, brokers' loans suddenly pushed out of their long rising channel. The upward penetration (arrow) of this channel marks the transition from increasing speculation to "white heat" or frenzy. In that final frenzy lay the seeds of the 1921-29 bull market's destruction. Note also that following 1929, brokers' loans began declining, and that by 1932 these loans were actually below the 1921 levels. By 1932, the speculator was indeed "exhausted".

Turning to the current picture, note that in early 1963 the debit loans (which are comparable to the brokers loans of the 1920's) pushed out of a long ascending channel. It is probable that we have again witnessed a transition from increasing (margin) speculation to frenzied speculation. And while history never repeats itself exactly, I believe the implications of the current debit balance picture are now clear enough.

In summing up, two concepts present themselves: (1) The higher the debit loans climb from here, the more speculative this market is likely to become. (2) Debit loans have soared into the "blue yonder" and have now reached the point of no-return. When they finally begin dropping, it will pay all of us to "have our houses fully in order".

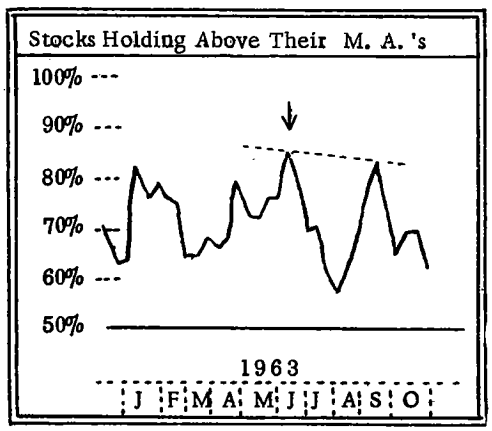
LATE NOTES On October 30, the Rail Average broke below its October 9 low (see Chart #1), while the A-D ratio sank to its lowest level since mid-August (see Chart #2). Industrials also declined sharply on October 30, but so far Industrials are far from confirming the successive lows in the Rails and the A-D ratio.

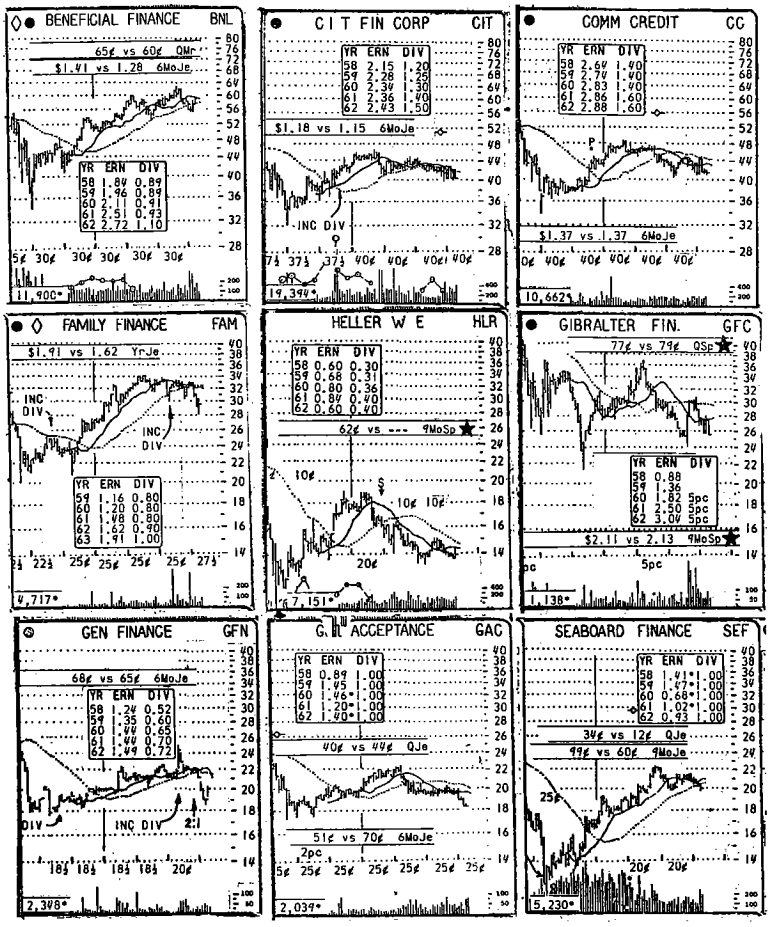
The pattern from here could take the form of (1) a continuing series of new Industrial highs against a declining trend in the majority of issues, or (2) Industrials could (at any time) decide to "get in gear" with the generally sagging market. Either way, traders and investors should keep one fact in mind -- the majority of issues on the N. Y. S. E. are in a declining trend.

STOCKS Of 432 stocks which are tabulated here each week, 275 (64%) are now holding above their 200-day moving average, a drop of 6% from last week (tabulations are from Quote Digest).

I have included a little chart (bottom of page) which traces the above tabulation over the past year. Note that the percentage of stocks holding above their moving average has been consistently above the critical 50% level. The peak of strength, however, came around late May, and this corresponds exactly to the peak on the A-D ratio. The resurgence of strength in September failed to match the May strength, and the percentage line has been dropping since then. The final "danger signal" on this study will be given when the percentage line drops below 50%. When and if this occurs, it will, of course, be reported in this section.

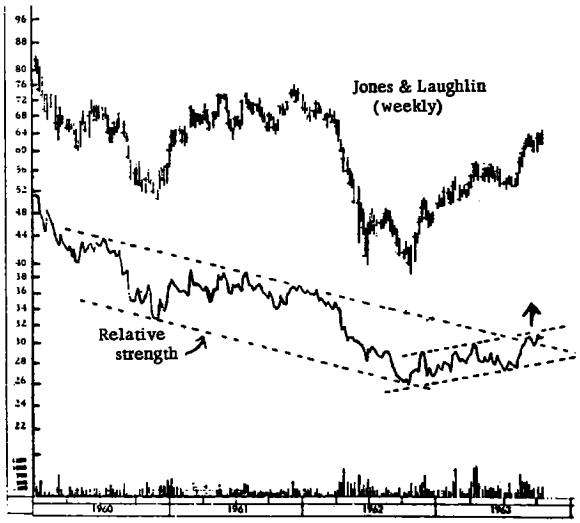
I have included 13 charts on this page, and the story they tell is an important one. These charts represent "money stocks" -- small loan companies, auto finance and factoring companies, and savings and loan holding

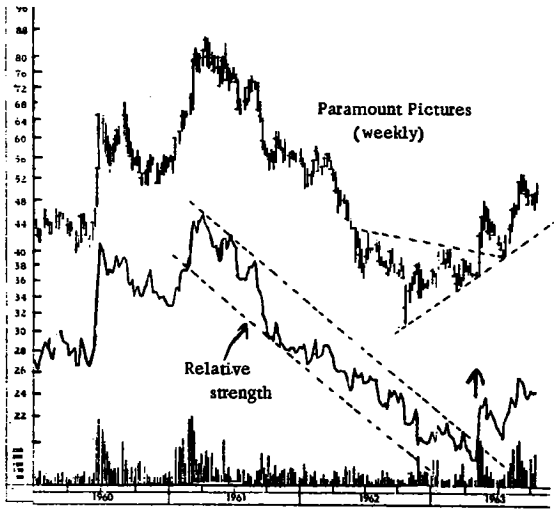




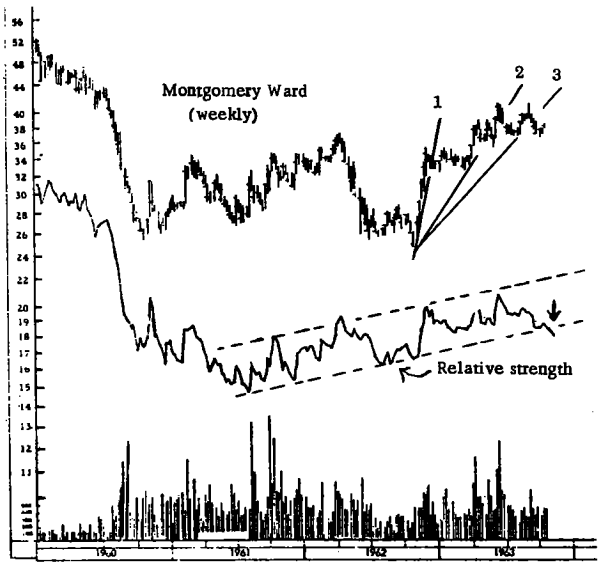
companies. As a group, the entire Finance sector of the market is "topping out". Are these stocks heading down in anticipation of rising interest rates, have they already discounted a peak in consumer spending and financing, is there a credit crisis ahead? A number of explanations may be advanced to explain what is going on in the finance stocks, but I do not profess to know the answer. One thing is clear -- subscribers should sell any holdings in the Finance group. Furthermore, I believe that token shorts may be put out in such issues as Family Finance and Seaboard Finance.

Jones & Laughlin in the supervised account continues to act better than the market. The weekly chart below shows JL breaking above the three year channel of declining relative strength (R. S.). The stock has now formed a smaller rising channel of R. S. Note that the low in popularity (R. S.) occurred in late 1962.





The motion picture group has been in a bearish relative strength trend since March, 1961. However, the group now shows indications of a reversal in R. S. One stock in the group which acts particularly well is Paramount (below). PXN broke out of a large triangle, and the move was strongly confirmed by a reversal in a two-year downtrend in R. S. This stock is probably going to continue to act better than the market, and it is a good hedge for the bulls.



On the other hand, Montgomery Ward, which was the subject of many optimistic reports over the summer, now appears to be turning bearish. Note the application of the "fanline" principle on the chart below. When the third trendline from the base was violated, it was a reasonable assumption that the upward move in M had reversed its upward trend. The penetration of the third fanline was confirmed by the cracking of a two year rise in R. S.

The portfolio at the bottom of the page is significant in that all the gains are in the shorts while the losses are confined to the longs. This in itself is a commentary on the current market. Note that "stop losses" ("stop buys" in the case of longs) are now listed. In a few cases (such as Addresso-Multi) there are no clear near-by "support levels" for placing good stop-losses. In such cases, however, losses must be limited, and I will place stops at an arbitrary percentage figure below the purchase price. In other cases (such as Torrington) where a stock begins to show a profit I will follow it with stops, thereby limiting potential losses or guaranteeing a profit. Subscribers should remember that all the above procedures refer to trading and speculation -- not investing during periods in which stocks represent "great values".

Date	Name	Price Stock bought	Price Stock shorted	Place stops at	Current price	Current gain or loss
Oct. 23	Florida Pow. & Lt.		72	75	70	+ 2
Oct. 23	North Amer. Av.		48 1/2	50	47 1/2	+ 1
Oct. 23	Torrington Co.		65	65	62 1/2	+ 2 1/2
Oct. 23	Texaco		68	73	66 1/2	+ 1 1/2
Oct. 23	Emerson Radio	12 1/4		11	12 1/2	+ 1/4
Oct. 23	Addresso-Multi	67		62	64 1/2	- 2 1/2
Oct. 23	Goodyear	42 1/2		38	41 5/8	- 7/8
Oct. 23	Jones & Laughlin	63		59	62 1/2	- 1/2

Stock charts on page 3 courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Charts on this page courtesy of Traders Research, 1431 Pearl Ave., Alton, Ill.